State of Rhode Island
Office of the General Treasurer

Liquid Credit Implementation – Convertible Bonds

Staff Memo

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SUMMARY

Convertible bonds are hybrid corporate debt securities that can be considered for inclusion within the ERSRI Income Bucket's Liquid Credit allocation. Convertible bonds compliment the Liquid Credit allocation's existing High Yield exposure, expanding the equity-sensitive credit investment opportunity set.

CONVERTIBLE BOND OVERVIEW

Convertible bonds are corporate debt securities that can be converted into a specified number of shares of the issuer's common stock. Companies raise capital through convertible bond issue as a means to reduce interest expense; companies can issue convertibles at lower rates than they would otherwise have to pay via traditional bond issuance. This can be particularly advantageous for high-growth companies with lower credit ratings. Convertible bonds also allow companies to delay equity shareholder dilution when raising capital. Investors accept lower interest payments in return for the value of the security's conversion feature, which allow investors to participate in equity market upside while maintaining downside protection vis-à-vis the bond floor. As of December 31, 2021, the market value of US convertible bond market is ~$350 billion.

PORTFOLIO FIT

As liquid corporate debt securities, convertible bonds fit alongside ERSRI's High Yield exposure within the Income Bucket's Liquid Credit allocation.

+ ***Issuer and Sector Diversification:*** Convertible bonds provide exposure to sectors that are underrepresented in the High Yield market. The convertibles market skews towards high-growth sectors like Technology and Healthcare, while the High Yield bond market is more concentrated in value-oriented sectors like Energy and Industrials. The convertibles market contains issuers that are less accessible – or even inaccessible – in other debt markets. A sizable proportion of convertible bond issuers have debt structures that are predominantly comprised of convertibles. Pairing convertible bonds with ERSRI's existing High Yield allocation expands the credit investment opportunity set.

+ ***Asymmetric Returns***: Convertible bonds offer a uniquely convex pay-off pattern that isn't provided by other ERSRI portfolio allocations. Investors have the opportunity to participate in equity upside without taking straight equity risk, thanks to the downside protection offered by the bond floor. Over the trailing 10-year period, the broad US convertible bond market has asymmetrically captured 75% of the US equity market upside and only 70% of the downside. [1]

+ ***Interest Rate Risk***: Convertible bonds are less sensitive than straight bonds to changes in interest rates and spreads. Convertibles have a negative realized correlation to changes in interest rates.

+ ***Asset Class Dynamics***: As hybrid securities, convertible bonds don't often fit squarely into traditional asset allocation buckets. This, in conjunction with the asset class's unique complexities, can make convertible bonds under-owned. Convertible bonds are a niche asset class; at ~$10.5 billion AUM, ERSRI has the ability to make a meaningful allocation to convertibles and trade in the market without being disruptive.

[1] *Upside (downside) capture calculated as [(Annualized returns of BofA US Convertible Index during periods of positive (negative) MSCI US Index, Net returns)/(Annualized returns of MSCI US Index, Net during periods of positive (negative) MSCI US Index, Net returns)]*